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January 19, 1999

EX PARTE OR LATE FILED

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
Room 222
1919 M Street NW
Washington, D.C. 20554

Re: **EX PARTE** in CC Docket No. 96-128: Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996

Dear Ms. Salas:

Five topics are covered in this letter. First, a recent *ex parte* filed by the RBOC/GTE/SNET Coalition providing claimed call volumes at a break even payphone is evaluated. Second, a brief discussion is provided describing a logical inconsistency in the Commission's marginal payphone approach. The third topic concerns the payphone industry's data on call volumes, and their strategic manipulation thereof. Fourth, the letter evaluates the payphone industry's claims that reducing the per-call compensation rate will lead to a pandemic removal of payphones. Finally, and perhaps most importantly, the letter points to the fact that this proceeding is about consumers and not about companies - something that often gets lost in the morass of this highly contentious proceeding.

RBOC Coalition's Ex Parte

In a recent *ex parte* filing by the RBOC/GTE/SNET Coalition in CC Docket No. 96-128, Aaron M. Panner responded to a request by the Common Carrier Bureau "concerning the number of calls the various members of the Coalition require at a given location to place a public payphone ... for which no commissions are paid (p. 1)."[1] MCI WorldCom's interest in this letter arises from a concern that the number of calls, or rather the range of calls, provided by this study might be used by the Commission for purposes of defining the marginal payphone location as defined in the Second Report

[1] See Letter of Aaron W. Panner to Magalie Roman Salas, Dec. 8, 1998.

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and Order.[2] The purpose of this letter is to express our agreement with Aaron W. Panner that the call counts he has provided on behalf of the RBOC Coalition should not be used for that purpose. Indeed, if the Commission were to do so, MCI WorldCom believes this would raise substantial concerns with the outcome of the Commission's upcoming decision.

While Mr. Panner provides numerous reasons why the call counts provided in his letter (414 to 464 calls per month) should not be interpreted to represent the marginal payphone location as defined by the Commission, it is his comment in footnote 4 that commands further attention. In footnote 4, Mr. Panner notes that "[a]n additional difficulty in accounting for per-call compensation calls is that the final value of compensation for such calls has of course not yet been determined...." Indeed, since the chosen per-call compensation amount -- presently undetermined and the subject of this proceeding -- will directly influence the call volume at which a payphone will be placed, the logical basis for the use of these call volumes to determine the rate is inherently circular. The use of Mr. Panner's numbers to determine the per-call compensation amount locks the Commission into the following logic: prices determine call volumes, call volumes determine prices, prices determine call volumes, etc. In order to determine the minimum number of calls required to locate a payphone, one must know *ex ante* the prices for the various calls.[3]

The Marginal Phone

Both sides agree that the use of the call counts provided by the RBOC Coalition in its December 8, 1998 *ex parte* is inappropriate as a measure of call counts for the Commission's marginal phone analysis. As described below, the Commission's marginal phone analysis is suspect itself.

Consider the Commission's logic for the use of the marginal phone:

> [a]t the equilibrium price for payphone calls, newly installed payphones would be expected to generate just sufficient calls to earn only a normal return on investment. Thus, we believe that setting a default compensation rate to achieve fair and reasonable compensation requires that a payphone operator be able to cover costs at a low traffic location.... We select the number of calls to represent a low traffic location by estimating the number of calls that could cover all of the costs of operating a payphone with the exception of commissions paid to location owners (Second Order, ¶ 46-7).

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[2] CC Docket No. 96-128, FCC 97-371 (October 9, 1997) ("Second Order"), ¶ 46-7.

[3] Algebraically, the marginal phone is defined as $P \cdot Q = C$, where P is price, Q is quantity, and C is monthly cost. If P and C are known, the value of Q is determined by dividing C by P. The RBOC Coalition figure of 414 cannot, however, represent Q for the Commission's marginal phone analysis because Q cannot be used to determine P, since P and C must be known in order to determine Q.

First, there is a fundamental error in the Commission's statement. "Newly installed payphones" need not just break even, since a new payphone installed in a new high traffic location (a new airport terminal for instance) will likely generate profits substantially above a normal return on investment. More appropriately, the Commission's definition of the marginal payphone is the location with the lowest volume of calls that is economically viable. In other words, if we ranked in descending order all economically viable payphone sites by call volume, then the Commission's marginal phone is the one that would be considered 'last.'

The most important piece of information provided in the Commission's analysis above is its recognition that the commission payments paid by payphone operators to location owners is an above normal return, i.e., a profit.[4] In the words of the Commission, the "low traffic location" will "earn only a normal return on investment" and the "low traffic location" is determined by "estimating the number of calls that could cover all of the costs of operating a payphone with the exception of commissions paid to location owners." According to the Commission, commission payments to a landlord are an above normal return, i.e., an economic profit. This return is roughly $45 per month on average.[5]

Knowing only the call volume of the average phone, the Commission was required to adjust the financial situation of the average phone to approximate that of the marginal phone. To reduce the revenue of the average payphone site so that revenues just cover costs (excluding commissions), the Commission reduced the number of calls at the payphone.[6] Holding prices constant, reducing the number of units sold will reduce revenues. In the Second Order, the Commission reduced the average call volume of 689 (associated with the profit of $45) to 542 calls per month. This lower call volume was then used to determine the compensation rate. For the top-down analysis, the Commission's avoided cost estimate was divided by the reduced number of calls to produce the per-call compensation rate. In a bottom-up cost analysis, the monthly total cost of operating a typical payphone (less coin-specific costs) is divided by the reduced call count to produce a per-call compensation rate.

What is odd about the use of the lower (or marginal phone) call volume to produce a per-call compensation rate is the effect of such an approach on the above normal returns (profits) of the average phone. As stated in the Second Order, the average phone (689 calls) earned an above normal return of $45 per month. With the new per-call compensation rate of $0.284, the average phone earns an above normal return of about $55 per month - a 22 percent increase. By attempting to set the compensation rate at a break

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[4] In economic jargon, the Commission's approach simply reduces the demand faced by the average payphone monopolist (rotating it to the left on its vertical axis) until the monopolist just breaks even. The payphone is no less of a monopolist than before, just a less profitable one.

[5] Second Order, ¶ 49.

[6] The Commission makes an adjustment for the marginal cost of each call.

even level, the Commission devised a result whereby the profits of all existing payphone sites increase. The decision of a regulatory agency to set a compensation rate that increases the profits (above normal returns) by 22 percent of the already profitable two million payphones in operation, in the absence of a stated public policy reason to do so, is highly questionable.

At a more fundamental level, the marginal phone approach adopted by the Commission is inherently arbitrary. The call volume of the marginal phone depends on the price charged for calls and the cost of operating the phone. It is not sound to use the volume at the marginal phone to determine the price. In fact, there is no such thing as a marginal call volume. Increase the price, and the marginal call volume declines since more revenue is generated per call.[7] Decrease the price, and the marginal call volume rises since less revenue is earned per call. Any call volume can be marginal - just alter the price and a new marginal call count results. Not only is the choice of marginal call volume inherently arbitrary, but the Commission's approach is circular. The prices determine the marginal call volume, yet the Commission is using the marginal call volume to determine the prices.

Call Counts

The question of how many calls to use in the determination of the per-call compensation is critically important. Using the marginal phone for call volume is highly suspect. Far worse, however, would be the use of loose and unsupported guesses about call volumes submitted to the record by the payphone industry. For the top-down methodology employed by the Commission in the Second Order, the larger the number of calls, the higher will be the per-call compensation rate. It would be in the interest of the payphone industry, therefore, to provide high average call volumes. For a bottom-up approach, however, smaller call volumes increase the per-call compensation rate. The incentive of the payphone industry is to provide lower call volumes.

The position of the payphone industry on call volumes illustrates the perverse incentive at work here. In the Second Order, the call volumes submitted to the record were mostly in the upper 600 call range, and some exceeded 700.[8] The remand of the Second Order made the abandonment of the top-down cost approach for the more reasonable bottom-up approach imminent. For the payphone industry, smaller call volumes were needed. Not surprisingly, the RBOC Coalition began promoting an average call volume of 478 calls

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[7] Assuming inelastic demand, which all parties do.

[8] See Second Order, ¶ 49, Comments of Peoples Telephone (July 15, 1996), Albert H. Kramer and Robert F. Aldrich Letter to Magalie Roman Salas (Sept. 25, 1998). One month prior to the release of the Second Order, the RBOC Coalition provided an average call volume of 478 calls (Affidavit of Carl R. Geppert, Sept. 9, 1997). The Commission did not use this average in the Second Order, preferring the average of 689 calls provided by the APCC.

while the APCC filed documents indicating that their average call volumes had declined 15 percent (689 to 588) in 1997.[9] The RBOC Coalition's recent filing of 414 calls, which was completely unsupported, is a transparent attempt to drive up the per-call compensation rate that consumers, both business and residential, must pay to place a call at a payphone.

The Commission's mandate is to compensate payphone providers "fairly" for each and every completed call (§276(b)(1)(A)). Consider a scenario characterized as follows: *on average, payphone providers are fully compensated for the cost of dial-around and 800 calls.* This scenario, requiring only that the Commission divide the cost of an average payphone (eliminating coin specific costs and above normal returns) by average call volume, is simple, logical, and defensible. By contrast, overcompensating every coinless call, which is the result of the marginal phone approach, rewards the payphone operator at the ultimate expense of the payphone user. Whatever else can be said about Congressional intent in adopting new compensation requirements for payphones, this result appears at odds with the Act's purpose.

Perhaps the most desirable characteristic of the average-phone approach is that it is not plagued by the circular logic of the marginal phone. The circularity, however, is avoided only by using average call volumes prior to the implementation of the per-call compensation approach. Once a per-call compensation scheme is in place, the price determines the quantity and this quantity cannot be used in turn to determine the price. A flat, per-phone payment will not affect the marginal decisions of consumers (i.e., the number of calls). In the Second Order, the Commission accepted the APCC average call volume of 689 calls. While the RBOC Coalition claims that their average number of calls is 478, this number probably includes a non-trivial number of both semi-public and perhaps some unprofitable phones. So little information is provided by the Coalition on this figure that it is impossible to evaluate carefully. The Commission must have felt similarly since they chose not to rely on this lower call volume in the Second Order. Using the pre-compensation call volumes also eliminates the problem of reduced call volumes resulting from the recent 40 percent local coin rate increase as well as from the remanded per-call dial-around/800 compensation rates.

Payphone Deployment and the Removal Sham

The payphone industry has repeatedly asserted that reductions in the compensation rate will lead to the removal of payphones. The payphone industry's argument is as follows. A payphone will be located at a given site if the revenue generated exceeds the cost of

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[9] Neither the RBOC Coalition or the APCC provided enough information to evaluate their call volumes. Without question, semi-public and unprofitable payphones should not be included in these averages. It is also inappropriate to reduce call volumes resulting from the recent rise in both coin and coinless compensation rates since the Commission contends that (on average) payphone sites were earning above normal returns on investment prior to these increases.

installing and maintaining that payphone. A reduction in the price of one type of payphone call will likely reduce the revenue generated at that site. For any given level of costs, as revenues fall the number of sites that are economically viable decline. This very simple theory of the payphone industry has been employed for various purposes by all participants to this proceeding. It is reasonably sound.

The problem with the claim of the payphone industry is that almost any compensation rate would be a marked improvement over the pre-Act compensation level. Even for the very low call volumes recently offered by the RBOC Coalition (414 calls), the monthly dial-around/800 compensation amount will exceed substantially the former compensation amount of $6 per-payphone/per-month– the compensation rate that existed prior to the Act and the only compensation amount that has not been remanded by the Court.

For example, APCC provides data suggesting that on average about 30 percent of all calls are non-coin.[10] At the RBOC Coalition's proposed break even call volume of 414 calls, roughly 124 of those calls are non-coin. At a $0.20 compensation rate, the RBOC Coalition's break even phone would receive nearly $25 per month in compensation – a whopping 400 percent increase in monthly compensation. In fact, a compensation rate of $0.05 per non-coin call would lead to an increase in monthly compensation ($6.20).

The Commission's success in increasing the deployment of payphone services should be evaluated using the pre-Act quantity of such services, and the contribution of dial-around/800 calls to that quantity was based on a $6 per-payphone/per-month compensation rate. Clearly, the payphone industry's claim that lower per-call compensation rates will force them to remove payphones is a sham and nothing more than an attempt to scare the Commission into setting a higher compensation rate. Any rate in excess of $0.05 per call will satisfy the Act's mandate to promote the deployment of payphone services, even if the Commission failed to accomplish any of the Act's other mandates specifically designed to do so.

A Concern for Consumers

Whatever the total compensation the payphone industry receives from dial-around/800 calls turns out to be, that compensation amount will be funded out of the pockets of consumers, whether residential, business, poor, rich, educated, or uneducated. The higher are compensation costs for the interexchange industry, the higher are the prices for payphone originated services. Any windfall profits to the payphone industry caused by high per-call compensation rates will quickly be transferred to premise owners as

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[10] APCC data indicates that in 1996 roughly 28 percent of all calls were non-coin calls. In 1997, the percentage of non-coin calls was 32 percent. See Albert H. Kramer and Robert F. Aldrich Letter to Magalie Roman Salas (Sept. 25, 1998), p. 4.

payphone operators compete for the right to place a payphone. In the end, higher compensation leads to little more than higher rates for consumers, a reduced quantity of payphone services consumed (which seems at odds with the Act's mandate in §276(b)(1)), and thus substantial reductions in consumer well-being.

Sincerely,

George S. Ford

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